

Journal of Law and Policy

Volume 19 | Issue 1

Article 15

2010

Reform After the Reform Act

Kendra Schramm

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/jlp>

Recommended Citation

Kendra Schramm, *Reform After the Reform Act*, 19 J. L. & Pol'y (2010).
Available at: <https://brooklynworks.brooklaw.edu/jlp/vol19/iss1/15>

This Note is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Journal of Law and Policy by an authorized editor of BrooklynWorks.

REFORM AFTER THE REFORM ACT

*Kendra Schramm**

INTRODUCTION

The first federal securities laws were enacted in the wake of a financial crisis and the Great Depression.¹ As part of the New Deal, the Securities Act of 1933 (“Securities Act”) was designed to create transparency in companies that offer securities to the investing public (“issuers”).² The following year, the Securities Exchange Act of 1934 (“Exchange Act”) was passed, creating a system of regulation for broker-dealers, securities associations, and exchanges.³ In simple terms, these laws require issuers to provide

* Brooklyn Law School, J.D. Candidate, 2011.

¹ See Securities Act of 1933, 15 U.S.C.A. §§ 77a–aa (West 2010); Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78a–lll (West 2010).

² *FDR Press Conference May 31, 1935*, NEW DEAL NETWORK, http://newdeal.feri.org/court/fdr5_31_35.htm (last visited Nov. 4, 2010) (“The Securities Act . . . was intended to prevent nationally the issuing of securities to the investing or speculating public under false pretenses. The Act required that, through a central Federal organization, securities that were proposed to be issued should have the full truth stated about them.”); see § 77b (“The term ‘issuer’ means every person who issues or proposes to issue any security . . .”).

³ §§ 78a–lll. See § 78b:

[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . to require appropriate reports to remove impediments to and perfect the mechanisms of a national market system for securities . . . and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in

regular and reliable financial disclosure to the investing public⁴ and prohibit fraudulent conduct in connection with the purchase or sale of securities.⁵ In enacting these laws and their subsequent amendments,⁶ Congress intended to “promote investor

such transactions.

⁴ This includes quarterly and annual filings of financial statements with the SEC as well as special disclosure for triggering events such as bankruptcy, mergers and acquisitions, and changes in corporate governance or management. *See, e.g., Form 8-K*, SEC, <http://www.sec.gov/answers/form8k.htm> (last visited Sept. 24, 2010) (“In addition to filing annual reports on Form 10-K and quarterly reports on Form 10-Q, public companies must report certain material corporate events on a more current basis. Form 8-K is the ‘current report’ companies must file with the SEC to announce major events that shareholders should know about.”); *Form 10-K*, SEC, <http://www.sec.gov/answers/form10k.htm> (last visited Sept. 24, 2010) (“The annual report on Form 10-K provides a comprehensive overview of the company’s business and financial condition and includes audited financial statements.”); *Form 10-Q*, SEC, <http://www.sec.gov/answers/form10q.htm> (last visited Sept. 24, 2010) (“The Form 10-Q includes unaudited financial statements and provides a continuing view of the company’s financial position during the year. The report must be filed for each of the first three fiscal quarters of the company’s fiscal year.”).

⁵ *See* §§ 77a–aa, 78a–lll; *see also* *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976):

The Securities Act of 1933 was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. The Securities Exchange Act of 1934 was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.

⁶ *See, e.g.,* Trust Indenture Act of 1939, 15 U.S.C.A. §§ 77aaa–bbbb (West 2010) (supplementing the Securities Act of 1933 in regard to debt securities); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at various sections of 15, 18 U.S.C.); Investment Company Act of 1940, 15 U.S.C.A. §§ 80a-1–64 (West 2010) (establishing standards for regulation of investment companies “to mitigate and . . . eliminate the conditions . . . which adversely affect the national public interest and the interest of investors”); Investment Advisers Act of 1940, 15 U.S.C.A. §§ 80b-1–21 (West 2010) (establishing standards for regulation of

confidence . . . and thereby to encourage the investment necessary for capital formation, economic growth, and job creation.”⁷ Violations of the securities laws, which generally consist of fraudulent conduct, preclude investors from effectively monitoring the performance of a public company and its management, and often cause inflation of stock price.⁸ There are several avenues through which federal securities laws are enforced; the government brings civil actions, administrative actions,⁹ and criminal prosecutions¹⁰ and private parties bring direct and derivative actions.¹¹

This Note will focus on the enforcement of federal securities laws¹² through private class action litigation, which is governed in part by the Private Securities Litigation Reform Act of 1995 (“PSLRA” or “Reform Act”), an amendment to the Exchange Act.¹³ Additionally, this Note will discuss the primary legislative goal behind the creation of the Reform Act: to reduce the incidence of meritless litigation.¹⁴ Although some provisions of the Reform Act were successful in promoting this narrow goal,¹⁵ this

investment advisers).

⁷ S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

⁸ Marilyn F. Johnson et al., *In re Silicon Graphics, Inc.: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act’s Pleading Standard*, 73 S. CAL. L. REV. 773, 778 (2000) [hereinafter *Shareholder Wealth*].

⁹ *See infra* notes 26–32 and accompanying text.

¹⁰ *See infra* notes 33–43 and accompanying text.

¹¹ *See infra* notes 44–55 and accompanying text.

¹² Although not addressed in this Note, it is also important to consider the role of state securities laws, commonly referred to as ‘Blue Sky’ laws and the contribution of state attorneys general and state regulatory agencies in monitoring the integrity of markets and protecting investors, see generally Michael J. Missal et al., *Blue Sky Enforcement: The Increasing Activism of State Securities Regulators*, in THE SECURITIES ENFORCEMENT MANUAL 523–53 (2d ed. 2007); *see also* N. AM. SEC. ADMIN. ASS’N, <http://www.nasaa.org/> (last visited Sept. 24, 2010).

¹³ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

¹⁴ S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

¹⁵ *See infra* Part I.B.

legislation is not entirely compatible with the broader legislative purpose behind the creation of private rights of action for violations of the federal securities laws. Such suits were meant not only to provide a means for making injured shareholders whole through the recovery of damages,¹⁶ but also to help promote diligence and deter misconduct—"to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs."¹⁷ Ultimately, shareholder litigation is beneficial because it creates the perception that individuals will be held liable for their misconduct.¹⁸ This deters violations of the federal securities laws because individuals are sensitive to liability exposure.¹⁹ In turn, the perception of enforcement increases the confidence of the investing public and, thereby, the efficiency of capital markets.²⁰ This Note suggests that additional reform for the structure of private securities litigation and greater public enforcement is necessary to compensate defrauded investors and to deter violations of the securities laws.

Part I of this Note will provide general background information regarding the federal securities laws; briefly explain liability under

¹⁶ See generally H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 730 ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action.").

¹⁷ *Id.* See also James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 1 (1997) ("Compensating the injured and deterring future violations are frequently seen as complementary objectives of private suits.").

¹⁸ See generally Geraldine Szott Moohr, *Arbitration and the Goals of Employment Discrimination Law*, 56 WASH. & LEE L. REV. 395, 431 (1999) ("General deterrence requires public knowledge of disputes and their disposition. Potential violators can appreciate the threat of sanctions only when they learn that similarly situated actors have been punished. This knowledge enables them to calculate the costs and benefits of engaging in the prohibited conduct.") (internal quotation marks omitted).

¹⁹ Susanne Mast Murray & Fred T. Podolsky, *Protecting Your Directors and Officers from Liability: Examining Indemnification and Insurance*, in WHAT EVERY DIRECTOR & OFFICER SHOULD KNOW ABOUT D&O COVERAGE 2005, at 56 (PLI Corp. Law & Practice, Course Handbook Ser. No. 1519, 2005), available at Westlaw, 1519 PLI/Corp 53.

²⁰ See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 318 (2007).

the provisions that plaintiffs invoke most frequently, Section 10(b) of the Exchange Act²¹ and SEC Rule 10b-5;²² and discuss significant provisions of the Reform Act.²³ Part II will argue for additional reform of private enforcement, including the codification of a private right of action for aiding and abetting violations of Section 10(b) and Rule 10b-5. Part III will consider enhanced criminal enforcement as an alternative form of deterrence. This Note will conclude by suggesting that deterrence, however achieved, should be the focus of additional reform.

I. BACKGROUND

The Exchange Act created the Securities and Exchange Commission (“Commission” or “SEC”),²⁴ a regulatory agency that seeks “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”²⁵ The SEC issues rules and regulations necessary to enforce the federal securities laws.²⁶ It also has the authority to investigate violations²⁷ and to bring civil

²¹ 15 U.S.C.A. § 78j (West 2010):

It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

²² Rule 10b-5 was promulgated under Section 10(b) of the Exchange Act. 17 C.F.R. § 240.10b-5 (West 2010).

²³ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

²⁴ See § 78d.

²⁵ *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, <http://www.sec.gov/about/whatwedo.shtml> (last visited Sept. 24, 2010) [hereinafter *What We Do*].

²⁶ 15 U.S.C.A. § 77s (West 2010) (“The Commission shall have authority . . . to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title . . .”).

²⁷ § 78u(a)(1) (“The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter, the rules or regulations thereunder . . .”).

and administrative actions.²⁸ Through these actions, the SEC generally seeks injunctions,²⁹ fines,³⁰ and sanctions.³¹ It may also seek disgorgement of ill-gotten gains and use the recovered funds to compensate investors for their losses.³²

²⁸ The SEC enforces the following laws: Securities Act of 1934, Exchange Act of 1934, Trust Indenture Act of 1939, Investment Company Act of 1940, Investment Advisors Act of 1940, and Sarbanes-Oxley Act of 2002. *What We Do*, *supra* note 25.

²⁹ § 78u(d)(1):

Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder . . . it may in its discretion bring an action . . . to enjoin such acts or practices . . .

³⁰ *See e.g.*, § 78u(d)(3)(A):

Whenever it shall appear to the Commission that any person has violated any provision of this chapter, the rules or regulations thereunder . . . the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

³¹ Courts may bar defendants who violate the anti-fraud provisions of the securities laws from future service in the management of a public company. § 77t(e):

[T]he court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated section 77q(a)(1) of this title from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 78l of this title or that is required to file reports pursuant to section 78o(d) of this title if the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer.

A study of actions between 1978 and 2004 found 697 enforcement actions by the SEC and DOJ, on average, fewer than 27 per year. These resulted in close to 4,500 sanctions against individuals, hundreds of whom were barred from future service in public corporations and financial institutions. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 275 (2007) [hereinafter *Law and the Market*] (internal citation omitted).

³² § 78u(d)(5) ("In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors."). Pursuant to the Sarbanes-Oxley Act of 2002, the SEC can compensate investors through the Federal Account for Investor Restitution provision, or 'Fair Funds.' 15 U.S.C.A. §

On the criminal side of public enforcement, the Department of Justice (“DOJ”) has authority to prosecute securities fraud³³ and other related offenses, such as conspiracy,³⁴ mail and wire fraud,³⁵ failure of corporate officers to certify financial reports,³⁶ and racketeering.³⁷ Convicted persons may be imprisoned up to five years for willfully violating the Securities Act³⁸ and up to twenty years for offenses such as obstruction of justice by alteration or destruction of documents.³⁹ In addition to incarceration, the DOJ

7246(a) (West 2010). *See e.g.*, SEC v. Henke, 275 F. Supp. 2d 1075, 1086 (N.D. Cal. 2003) (applying § 7246(a)). *But see infra* notes 164–69 and accompanying text.

³³ *See* 18 U.S.C.A. § 1348 (West 2010).

³⁴ *See* 18 U.S.C.A. § 371 (West 2010) (conspiracy to commit offense or to defraud the United States); 18 U.S.C.A. § 1349 (West 2010) (attempt and conspiracy).

³⁵ *See* 18 U.S.C.A. § 1341 (West 2010) (mail fraud); 18 U.S.C.A. § 1343 (West 2010) (wire fraud).

³⁶ *See* 18 U.S.C.A. § 1350 (West 2010).

³⁷ *See* 18 U.S.C.A. § 1962 (West 2010). A study of criminal actions between 1978 and 2004 found 755 individuals were indicted, resulting in 543 guilty pleas and only 10 acquittals; “[a] total of 1230.7 years of incarceration and 397.5 years of probation were imposed (with the average being 4.2 years).” *Law and the Market*, *supra* note 31, at 275–76 (“Since the Department of Justice’s Corporate Fraud Task Force was formed in 2002 in the wake of Enron, it has charged over 1300 defendants and obtained over 1000 guilty pleas and convictions.”).

³⁸ 15 U.S.C.A. § 77x (West 2010):

Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than \$10,000 or imprisoned not more than five years, or both.

³⁹ Sarbanes Oxley Act of 2002, 18 U.S.C.A. § 1519 (West 2010). This legislation “imposes more stringent governance and accounting control requirements on public companies in an effort to deter fraud.” Marilyn F. Johnson, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627, 649 (2007) [hereinafter *Do Merits Matter More?*]:

These mechanisms may reduce companies’ litigation risk by reducing

may seek criminal fines,⁴⁰ forfeiture,⁴¹ or restitution.⁴² The DOJ also has the authority to use recovered funds to compensate investors for their losses.⁴³

Finally, an issuer, its directors and officers,⁴⁴ and, in some cases, outside entities such as auditors and underwriters may be held civilly liable in direct or derivative actions.⁴⁵ Several provisions of the Securities and Exchange Acts expressly create private rights of action for violations of the federal securities

the overall incidence of fraud. On the other hand, the Sarbanes-Oxley Act also requires the chief executive officer and the chief financial officer to certify their company's financial results, which could expose these executives and their companies to additional litigation risk because it provides additional evidence of scienter if those financial results are misstated. Litigation risk may also have been increased by the Sarbanes-Oxley Act's lengthening of the statute of limitations for securities fraud claims.

⁴⁰ See, e.g., 18 U.S.C.A. § 1519 (2010)

⁴¹ See 18 U.S.C.A. § 981 (West 2010) (civil forfeiture); 18 U.S.C.A. § 982 (West 2010) (criminal forfeiture).

⁴² See 18 U.S.C.A. § 3663 (West 2010) (restitution).

⁴³ See *infra* notes 164–69 and accompanying text.

⁴⁴ See 15 U.S.C.A. § 77o (West 2010):

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C.A. § 78t(a) (West 2010):

Every person who, directly or indirectly, controls any person liable under any provisions of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation of cause of action.

⁴⁵ See *infra* notes 47–52 and accompanying text.

laws.⁴⁶ For example, liability results from material misstatements or omissions in registration statements,⁴⁷ violations of registration and prospectus provisions,⁴⁸ use of false or misleading prospectuses or communications in connection with offers or sales of a security,⁴⁹ manipulation of security prices,⁵⁰ false filings with the SEC,⁵¹ and insider trading.⁵² These claims are, usually, consolidated into class actions where the plaintiffs are numerous and geographically scattered⁵³ and their claims are not cost-effective to litigate individually.⁵⁴ These actions also supplement the efforts and resources of the SEC and DOJ in policing market integrity.⁵⁵

⁴⁶ Acting as private attorneys general, individual and class plaintiffs ‘vindicate the public interest’ through private enforcement of securities laws. *Associated Indus. v. Ickes*, 134 F.2d 694, 704 (2d Cir. 1943); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 918 (2003) [hereinafter *Did PSLRA Work?*] (“Giving private attorneys a financial stake in the outcome of a case effectively deputizes them to search out fraud cases that the resource-constrained SEC may be unable to bring.” (citing *Ickes*, 134 F.2d at 704)).

⁴⁷ See § 77k.

⁴⁸ See § 77l(a)(1).

⁴⁹ See § 77l(a)(2).

⁵⁰ See § 78i(e).

⁵¹ See § 78r(a).

⁵² See § 78t-1(a).

⁵³ See, e.g., 7 WILLIAM B. RUBENSTEIN ET AL., *NEWBERG ON CLASS ACTIONS* § 22:16 (4th ed. 2010) (“In cases involving securities traded on the national stock exchanges, class members are usually so geographically dispersed and numerous that the joinder impracticability requirement is easily satisfied.”).

⁵⁴ See PAUL, HASTINGS, JANOFSKY & WALKER, L.L.P., *SECURITIES LAW CLAIMS: A PRACTICAL GUIDE* 157 (2004):

The class action is widely viewed as a favored device for pursuing and managing shareholder lawsuits based on alleged violations of the federal securities laws [T]he United States Supreme Court recognized . . . grouping smaller, individual shareholder claims by means of the class action device promotes judicial efficiency and equalizes the relative power of the litigants.

(citing *Philips Petroleum v. Shutts*, 472 U.S. 797, 809 (1985) (“Class actions . . . may permit the plaintiff to pool claims which would be uneconomical to litigate individually”)).

⁵⁵ See *Lampf v. Gilbertson*, 501 U.S. 350, 376 (1991) (Kennedy, J.,

A. Liability Under Section 10(b) of the Exchange Act and SEC Rule 10b-5

Private plaintiffs most frequently assert claims under the broad and general anti-fraud provisions, Section 10(b) and Rule 10b-5.⁵⁶ Rule 10b-5, promulgated by the SEC under Section 10(b), provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.⁵⁷

Although neither Section 10(b) nor Rule 10b-5 expressly creates a private civil remedy, trial courts consistently recognized an implied right of action and this practice was eventually affirmed by the Supreme Court in *Ernst & Ernst v. Hochfelder*.⁵⁸

To prevail on a claim for a violation of Section 10(b) and Rule 10b-5, a plaintiff must establish several elements: (1) standing,

dissenting); *Law and the Market*, *supra* note 31, at 267 (internal citations omitted).

⁵⁶ See *SEC v. Tambone*, 550 F.3d 106, 121 (1st Cir. 2008), *reh'g granted*, 573 F.3d 54 (2009) ("Because of its broad scope and its availability to private plaintiffs, Rule 10b-5 'is the most commonly used basis for private suits charging fraud in connection with the purchase or sale of securities.'" (citing 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SEC. REG. § 12.4[1] (5th ed. 2005))).

⁵⁷ 17 C.F.R. § 240.10b-5 (West 2010).

⁵⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976).

through the purchase or sale of the security in question; (2) a misstatement or omission by the defendant;⁵⁹ (3) materiality of the misstatement or omission; (4) that the defendant acted with scienter—having “a mental state embracing intent to deceive, manipulate, or defraud”;⁶⁰ (5) the plaintiff’s reliance on the misstatement or omission in the purchase or sale of the security in question; (6) loss causation; and (7) damages.⁶¹ Proof of actual reliance is unnecessary because of the fraud-on-the-market theory, which assumes that “[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.”⁶²

Prior to 1994, each of the circuit courts also recognized an implied right of action against parties indirectly responsible for fraudulent activities on the theory of aiding and abetting violations of Section 10(b) and Rule 10b-5.⁶³ Plaintiffs were required to

⁵⁹ For example, a frequent, although not necessarily fraudulent, cause of an issuer’s misstatement is a violation of the Generally Accepted Accounting Principles that results in an earnings restatement. *See Do Merits Matter More?*, *supra* note 39, at 633–34; *see generally Generally Accepted Accounting Principles*, FED. ACCT. STANDARDS ADVISORY BD., <http://www.fasab.gov/accepted.html> (last visited Sept. 24, 2010).

⁶⁰ *Hochfelder*, 425 U.S. at 193 n.12.

⁶¹ *See, e.g., Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

⁶² *Basic, Inc. v. Levinson*, 485 U.S. 224, 242, 247 (1988) (“Because most publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.”).

⁶³ *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 192 (1994) (Stevens, J., dissenting) (“[A]ll 11 Courts of Appeals to have considered the question have recognized a private cause of action against aiders and abettors under § 10(b) and Rule 10b-5.” (citing *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 799–800 (3d Cir. 1978); *Schatz v. Rosenberg*, 943 F.2d 485, 496–97 (4th Cir. 1991); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir.), *cert. denied*, 483 U.S. 1006 (1987); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 947 (7th Cir. 1989); *K & S P’ship v. Cont’l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *Schneberger v. Wheeler*, 859 F.2d

establish proof of “(1) a primary violation by another person; (2) the aider and abettor’s ‘knowledge’ of the primary violation; and (3) substantial assistance by the aider and abettor in the achievement or consummation of the primary violation.”⁶⁴ These actions were brought against outside entities—“reputational intermediaries who provide verification and certification services to investors”⁶⁵ Consistent with the stated goals of securities legislation, typical defendants included auditors, rating agencies, securities analysts, investment bankers, and attorneys.⁶⁶ Also

1477, 1480 (11th Cir. 1988); *Dirks v. SEC*, 681 F.2d 824, 844 (D.C. Cir. 1983) (recognizing, indirectly, aiding and abetting in private actions under Section 10(b) and Rule 10b-5)).

⁶⁴ *Rosenberg*, 943 F.2d at 495. *See generally* RESTATEMENT (SECOND) OF TORTS § 876(b) (1979) (providing liability for the fraudulent conduct of another when one “knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other”); Richard C. Mason, *Civil Liability for Aiding and Abetting*, 61 BUS. LAW. 1135 (2006) (discussing the elements of aiding and abetting liability).

⁶⁵ John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1404 (2002):

These services can consist of verifying a company’s financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company’s business and financial prospects vis-à-vis its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion). Lawyers can also be gatekeepers when they lend their professional reputations to a transaction Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client’s own statements about itself or a specific transaction.

See also Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 415–16 (2008) (citing Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986)).

⁶⁶ *See supra* notes 16–17 and accompanying text. *See generally* Mason, *supra* note 64 (discussing common aiding and abetting claims); Don J. McDermott, Jr., *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087, 1088 n.6 (1984) (“[M]any types of defendants are subject to secondary liability when they have some connection with a defendant who has violated an express prohibition of the securities laws . . . includ[ing] banks, . . . stock exchanges, . . . accountants, . . . and brokers.”); *id.* at 1089 n.10 (citing, as an example, a case in which plaintiffs asserted claims for aiding and abetting against “(1) 12

referred to as “gatekeepers,” they are, in theory, “de facto cops on the beat,”⁶⁷ who may have the opportunity to prevent fraud and “likely have less to gain and more to lose from firm delicts than inside managers.”⁶⁸

However, in a dramatic deviation from the circuit courts, the Supreme Court held in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* that there is no implied private right of action for aiding and abetting under Section 10(b) or Rule 10b-5.⁶⁹ Despite significant objections, the Reform Act was passed the next year without overturning that decision.⁷⁰ In 2008, the Supreme Court affirmed *Central Bank* in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*⁷¹ and recent attempts to codify a private right of action have been unsuccessful.⁷² Consequently, only the government may bring actions for aiding and abetting.⁷³

brokerage firms that executed stock transactions for the president, (2) 16 individuals associated with those firms, (3) the New York Stock Exchange, (4) a different bank, (5) the bank’s outside accountants, (6) the Federal Reserve Bank of New York, and (7) the Federal Deposit Insurance Corporation”).

⁶⁷ Kim, *supra* note 65, at 416.

⁶⁸ *Id.* However, it is generally noted that gatekeepers do not always have the capacity to detect and interdict misconduct and that this method of policing may not be as effective as internal corporate governance. *See, e.g., id.* at 412 (“If we want companies to fuse high performance with high integrity, the place to begin—and to be most effective—is inside the company itself. Outside regulators and gatekeepers can never be as potent and preventative as internal governance on the front lines from the CEO on down.” (quoting Ben W. Heineman, Jr., former general counsel, General Electric Co.)).

⁶⁹ *See generally* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

⁷⁰ *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.); *Cent. Bank*, 511 U.S. at 196 n.7 (Stevens, J., dissenting) (“Of course, when a decision of this Court upsets settled law, Congress may step in to reinstate the old law.”).

⁷¹ *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 155–56 (2008).

⁷² *See infra* notes 133–35 and accompanying text.

⁷³ *See id.*; 15 U.S.C.A. § 78u-2(a)(2) (West 2010) (authorizing SEC to assess money penalties for aiding or abetting securities law violations). This is also an indictable offense. *See* 18 U.S.C.A. § 2(a) (West 2010) (criminal liability for aiding and abetting the commission of an offense against the United States).

B. The Private Securities Litigation Reform Act of 1995

In 1995, Congress overrode a presidential veto⁷⁴ and passed the Reform Act.⁷⁵ In the decade leading up to this legislation, the perceived trend in securities litigation was for plaintiffs to leverage the burdensome costs of litigation and discovery against defendants, to induce settlement, regardless of the merits of their asserted claims.⁷⁶ Liability was often based on a theory referred to as “fraud by hindsight”—meaning that “a sudden drop in a company’s stock price was evidence that the issuer and its

⁷⁴ See Veto Message from the President, H.R. DOC. NO. 104-150, *reprinted in* 141 CONG. REC. H15214–15 (daily ed. Dec. 20, 1995):

I am not [] willing to sign legislation that will have the effect of closing the courthouse door on investors who have legitimate claims This country is blessed by strong and vibrant markets and I believe that they function best when corporations can raise capital by providing investors with their best good-faith assessment of future prospects, without fear of costly, unwarranted litigation. But I also know that our markets are as strong and effective as they are because they operate—and are seen to operate—with integrity While it is true that innocent companies are hurt by frivolous lawsuits and that valuable information may be withheld from investors when companies fear the risk of such suits, it is also true that there are innocent investors who are defrauded and who are able to recover their losses only because they can go to court.

⁷⁵ 109 Stat. 737.

⁷⁶ See 141 CONG. REC. H15220 (daily ed. Dec. 20, 1995) (statement of Rep. Hastert):

[S]pectators are misusing the law to virtually extort money from honest companies when no fraud has taken place. Frivolous class action suits are being filed . . . often forcing innocent companies to settle out of court rather than face massive court fees [D]uring the last 3 years, one out of every 12 companies listed on the New York Stock Exchange was sued for securities fraud.

See also *In re Heritage Bond Litig.*, 546 F.3d 667, 677 (9th Cir. 2008) (“Congress passed the PSLRA because it was distressed with the proliferation and cost of allegedly meritless federal securities class actions. The PSLRA sought to curb abusive and frivolous securities suits by imposing new procedural and substantive requirements.” (citing *U.S. Mortgage, Inc. v. Saxton*, 494 F.3d 833, 841 (9th Cir. 2007))); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 978 (9th Cir. 1999) (noting that Congress enacted the PSLRA in part to prevent abusive actions designed to “impose costs so burdensome that it [was] often economical for the victimized party to settle”).

management covered up the bad news that led to the price drop.”⁷⁷ Prior to the enactment of the Reform Act, approximately 93 percent of private securities class actions settled.⁷⁸ In addition, Congress reported finding evidence of several abusive practices:

- (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer’s stock price, without regard to any underlying culpability of the issuers, and with only faint hope that the discovery process might lead eventually to some plausible cause of action;
- (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability;
- (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and
- (4) the manipulation by class action lawyers of the clients whom they purportedly represent.⁷⁹

The general perception was that these “strike suits”⁸⁰ only benefitted plaintiffs’ attorneys, who were awarded large fees,⁸¹

⁷⁷ *Shareholder Wealth*, *supra* note 8, at 774.

⁷⁸ 141 CONG. REC. S17934-04 (daily ed. Dec. 5, 1995) (statement of Sen. D’Amato).

⁷⁹ *See id.*

⁸⁰ *See generally* Cal. Pub. Emp. Ret. Sys. v. WorldCom, Inc., 368 F.3d 86, 98 (2d Cir. 2004) (“The PSLRA was intended to curtail ‘strike suits’—i.e., meritless class actions alleging fraud in the sale of securities.” (citing H.R. REP. NO. 105-803 (1998) (Conf. Rep.))).

⁸¹ *See, e.g.*, PAUL, HASTINGS, *supra* note 54, at 164 (“Plaintiffs’ attorneys were taking an unconscionable share of class action settlements[] and [t]his abusive litigation was causing an enormous cost to business that was inevitably passed on to consumers and society as a whole without achieving sufficient countervailing benefits.”); *Did PSLRA Work?*, *supra* note 46, at 918 (“Compensation of attorneys performing this function is invariably through contingency fees. Those fees, which historically have ranged from twenty to thirty percent of recovery, are intended to compensate attorneys for litigation risk and for costs associated with searching out and prosecuting fraud claims.” (citing John C. Coffee, Jr., *Understanding the Plaintiff’s Attorney: The Implications of Economic Theory of Private Enforcement Law Through Class*

rather than shareholders, who typically recovered only pennies on the dollar.⁸² In response, legislators sought to reduce meritless litigation and settlement through several provisions of the Reform Act,⁸³ which (1) created special class action requirements,⁸⁴ (2) provided a statutory safe harbor for certain forward-looking statements,⁸⁵ (3) imposed a heightened pleading standard,⁸⁶ (4) set forth a scheme of proportionate liability,⁸⁷ and (5) instituted a mandatory bar on contribution among co-defendants after partial

and Derivative Actions, 86 COLUM. L. REV. 669, 679 (1986) (noting that the “system should encourage the attorney to invest in search costs and seek out violations of the law that are profitable for him to challenge”)).

Attorneys acting with insufficient monitoring had incentives to act primarily in their own self-interest, often to the detriment of the deterrent and compensation functions they were supposed to perform. Under these circumstance, attorneys had incentives to bring marginal or nonmeritorious cases for their settlement value, not because they believed that fraud actually occurred.

Id. at 920.

⁸² 141 CONG. REC. S17934 (daily ed. Dec. 5, 1995) (statement of Sen. D’Amato).

⁸³ See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). The PSLRA was enacted “(1) to encourage the voluntary disclosure of information by corporate issuers; (2) to empower investors so that they—not their lawyers—exercise primary control over private securities litigation; and (3) to encourage plaintiffs’ lawyers to pursue valid claims and defendants to fight abusive claims.” S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

⁸⁴ See 15 U.S.C.A. § 78u-4(a) (West 2010) (requiring notice, establishing procedure for the appointment of lead plaintiffs and the selection of lead counsel).

⁸⁵ See § 78u-5.

⁸⁶ See § 78u-4(b)(1) (requiring that “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed”); § 78u-4(b)(2) (requiring “proof that the defendant acted with a particular state of mind . . . [and that the complaint] state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”).

⁸⁷ See § 78u-4(f).

settlement.⁸⁸ The Reform Act may have been somewhat successful in curbing meritless litigation through the first of these three aspects; however, it also impedes recovery for injured shareholders and arguably has a reduced deterrent effect.

First, the Reform Act added additional class action requirements to give investor plaintiffs, rather than their attorneys, more control over private litigation.⁸⁹ In particular, this legislation requires disclosure of settlement terms to class members⁹⁰ and restricts attorney fees to “a reasonable percentage of the amount of any damages . . . paid to the class.”⁹¹ It also requires that the trial court appoint a lead plaintiff based on a determination of which plaintiff is “most capable of adequately representing the interests of class members.”⁹² The lead plaintiff then determines which attorney or firm will act as lead counsel, which is also subject to court approval.⁹³ These provisions provide attorneys with more time to investigate potential securities violations rather than racing to the courthouse to establish lead plaintiff and lead counsel designations.⁹⁴ The general result has been a reduction in abusive litigation practices and greater control by institutional investors.⁹⁵

Second, the Reform Act created heightened pleading

⁸⁸ See *id.*; see generally Judge Amy St. Eve & Bryce C. Pilz, *The Fault Allocation Provisions of the Private Securities Litigation Reform Act of 1995—A Roadmap for Litigants and Courts*, 3 N.Y.U. J.L. & BUS. 187 (2006).

⁸⁹ See S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

⁹⁰ See § 78u-4(a)(7) (requiring that counsel publish or otherwise disseminate proposed and final settlement agreements which include information such as potential outcome of the case, the reason for settlement, and attorneys fees or costs sought).

⁹¹ § 78u-4(a)(6).

⁹² See § 78u-4(a)(3)(B)(i).

⁹³ See § 78u-4(a)(3)(B)(v).

⁹⁴ See S. REP. NO. 104-98, at 11 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 690.

⁹⁵ See, e.g., Michael A. Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* (St. John's Univ. Sch. of Law Legal Studies Research Paper Ser., Paper No. 06-0055, 2006), *available at* <http://papers.ssrn.com/abstract=938722> (discussing the rise of the institutional investor as lead plaintiffs—particularly public pension funds).

requirements.⁹⁶ A complaint must state with particularity facts supporting allegations of misleading statements and omissions and facts giving rise to a strong inference of scienter.⁹⁷ Since the enactment of the Reform Act, the dismissal rate of private class action securities litigations has nearly doubled.⁹⁸ Additionally, the Reform Act created mandatory sanctions for abusive litigation, in violation of Federal Rule of Civil Procedure 11(b),⁹⁹ giving plaintiffs' counsel incentive to refrain from advancing meritless claims.

Third, the safe harbor provision shields persons from liability for false or misleading forward-looking statements unless plaintiffs can prove that the speaker made the statements with knowledge of their false or misleading content.¹⁰⁰ Generally, forward-looking statements contain projections regarding performance, financial condition, or operational objectives.¹⁰¹ Speakers must make these statements upon a reasonable basis and in good faith, and speakers must accompany forward-looking information with meaningful

⁹⁶ See § 78u-4(b)(1) (requiring that a complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

⁹⁷ See generally *Tellabs, Inc. v. Makor Issue & Rights, Inc.*, 551 U.S. 308 (2007) (reviewing legislative history and discussing the positions taken by the circuit courts).

⁹⁸ ELAINE BUCKBERG ET AL., *NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLDCOM AND ENRON THE NEW STANDARD?* 3 (2005).

⁹⁹ § 78u-4(c).

¹⁰⁰ § 78u-5(c). See also S. REP. NO. 104-98, at 16 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 695:

Fear that inaccurate projections will trigger the filing of securities class action lawsuit has muzzled corporate management. One study found that over two-thirds of venture capital firms were reluctant to discuss their performance with analysts or the public because of the threat of litigation. Anecdotal evidence similarly indicates corporate counsel advise clients to say as little as possible, because legions of lawyers scrub required filings to ensure that disclosures are as milquetoast as possible, so as to provide no grist for the litigation mill.

(internal citations omitted).

¹⁰¹ The SEC prohibited forward-looking disclosure until 1979 when it created a safe harbor for certain statements made with a reasonable basis and in good faith. See 17 C.F.R. § 240.10b-5 (West 2010).

cautionary statements.¹⁰² The safe harbor provision was included to encourage enhanced disclosure and was successful in that respect—one study found an immediate increase in both frequency and the mean number of forecasts issued by a sample of 523 high technology firms.¹⁰³ This is beneficial because adequate information is necessary to maintain a fair and efficient market.¹⁰⁴

Fourth, the Reform Act restricts joint and several liability to defendants who “knowingly committed a violation of the securities laws” and creates a scheme of proportionate liability in all other cases,¹⁰⁵ most importantly, for defendants who settle prior to a determination of proportionate fault.¹⁰⁶ Although in some instances solvent defendants must cover an uncollectible share of the

¹⁰² § 78u-5; 17 C.F.R. § 230.175 (West 2010); S. REP. NO. 104-98, at 16 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 695. The PSLRA essentially codified the common law ‘bespeaks caution’ doctrine. *See, e.g.*, SEC v. Merchant Capital, 483 F.3d 747, 767 (11th Cir. 2007) (“The bespeaks caution doctrine is ultimately simply ‘shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law.’” (quoting *Kaufman v. Trump’s Castle Funding*, 7 F.3d 357, 364 (3d Cir. 1993))).

¹⁰³ Marilyn F. Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, 39 J. ACCT. RES. 297, 323 (2001) (“The increase in prospective disclosure is primarily attributable to managers issuing more long horizon forecasts of good news and short horizon forecasts of bad news [W]e document that the change in disclosure is increasing in our estimate of firms’ ex ante risk of litigation.”).

¹⁰⁴ *See In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 7–8 (1st Cir. 2005) (“Efficiency refers to the flow of information in the relevant market and the effect of that information on the price of the stock.”).

¹⁰⁵ § 78u-4(f).

¹⁰⁶ *See* § 78u-4(f)(3)(A):

In any private action, the court shall instruct the jury . . . [or] shall make findings, with respect to each covered person and each of the other persons claimed by any of the parties to have caused or contributed to the loss incurred by the plaintiff, including persons who have entered into settlements with the plaintiff or plaintiffs, concerning—(i) whether such person violated the securities laws; (ii) the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff; and (iii) whether such person knowingly committed a violation of the securities laws.

judgment due to a co-defendant's insolvency¹⁰⁷—and may then seek contribution from the defaulting party¹⁰⁸—contribution may be limited significantly, based on a plaintiff's net worth. The Reform Act states that:

[e]ach covered person shall be jointly and severally liable for the uncollectible share if the plaintiff establishes that—

(I) the plaintiff is an individual whose recoverable damages under the final judgment are equal to more than 10 percent of the net worth of the plaintiff; and

(II) the net worth of the plaintiff is equal to less than \$200,000.¹⁰⁹

Where plaintiffs do not fall into either of these categories, the “total liability of a covered person [for uncollectible shares] may not exceed 50 percent of [his] proportionate share.”¹¹⁰ This aspect of the Reform Act was successful in its design because it inherently reduces the liability exposure of defendants with deep pockets but comparatively less culpability.¹¹¹ However, this scheme of proportionate liability is detrimental to injured shareholders because they bear the risk of a defendant's insolvency and ultimately may be inadequately compensated because of their net worth.¹¹²

Finally, the Reform Act established a mandatory bar on contribution among co-defendants after partial settlement.¹¹³ As

¹⁰⁷ Covered persons are required to cover uncollectible shares. *See* § 78u-4(f)(4); *see also* § 78u-4(f)(10)(C):

[T]he term ‘covered person’ means—(i) a defendant in any private action arising under this chapter; or (ii) a defendant in any private action arising under section 77k of this title, who is an outside director of the issuer of the securities that are the subject of the action

¹⁰⁸ *See* § 78u-4(f)(5)(A).

¹⁰⁹ *See* § 78u-4(f)(4)(A)(i).

¹¹⁰ *See* § 78u-4(f)(4)(A)(ii).

¹¹¹ *See* 141 CONG. REC. S17934 (daily ed. Dec. 5, 1995) (statement of Sen. D’Amato).

¹¹² *See* § 78u-4(f)(5)(A).

¹¹³ *See* § 78u-4(f)(7)(A):

A covered person who settles any private action at any time before final verdict or judgment shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the

one might expect, in complex cases involving multiple defendants, a global settlement is not always feasible. As a result, parties often enter into partial settlements, involving fewer than all defendants.¹¹⁴ In class actions, the trial court must hold a fairness hearing and approve a proposed settlement¹¹⁵ because “[j]udicial scrutiny over settlements is the most important safeguard against inadequate or conflicted representation by class counsel.”¹¹⁶ The

court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling covered person arising out of the action. The order shall bar all future claims for contribution arising out of the action—(i) by any person against the settling covered person; and (ii) by the settling covered person against any person, other than a person whose liability has been extinguished by the settlement of the settling covered person.

See, e.g., In re Heritage Bond Litig., 546 F.3d 667, 670 n.3 (9th Cir. 2008) (citing *AAL High Yield Bond Fund v. Deloitte & Touche, L.L.P.*, 361 F.3d 1305, 1311 (11th Cir. 2004) (noting that the PSLRA “essentially codified federal common law allowing for issuance of a bar order as part of a securities fraud class action settlement”)).

¹¹⁴ *See, e.g., In re HealthSouth Corp. Sec. Litig.*, 572 F.3d 854 (11th Cir. 2009); *Heritage*, 546 F.3d 667; *In re Rite Aid Corp. Sec. Litig.*, 396 F.3d 294 (3d Cir. 2005).

¹¹⁵ FED. R. CIV. P. 23(c), (e). Since a settlement binds all class members, “the trial judge [has] the duty of protecting absentees, which is executed by the court’s assuring the settlement represents adequate compensation for the release of the class claims.” *In re PNC Fin. Servs. Group, Inc.*, 440 F. Supp. 2d 421, 429 (W.D. Pa. 2006) (quoting *In re Presidential Ins. Co. Am. Sales Litig.*, 148 F.3d 283, 316 (3d Cir. 1998)).

¹¹⁶ Jonathan R. Macey & Geoffrey P. Miller, *Judicial Review of Class Action Settlements*, 1 J. LEGAL ANALYSIS 167, 167 (2009) (analyzing the level of judicial scrutiny of class action settlements). *See generally* Lawrence J. Zweifach & Samuel L. Barkin, *Recent Developments in the Settlement of Securities Class Actions*, in 33RD ANNUAL INSTITUTE ON SECURITIES REGULATION 2001, at 1331–34 (PLI Corp. Law & Practice, Course Handbook Ser. No. 1279, 2001), available at Westlaw 1279 PLI/Corp 1329 (describing the statutory framework governing a shareholder class action and the judicial standards applied in determining the fairness, reasonableness, and adequacy of a proffered settlement). In exercising its discretion, the trial court may consider a variety of factors, such as

- (1) The complexity, expense and likely duration of the litigation; (2) The reaction of the class to the proposed settlement; (3) The stage of the proceedings and the amount of discovery completed; (4) The risks of establishing liability; (5) The risks of establishing damages; (6) The

driving factor in settlement is a preference for control over the outcome rather than uncertainty.¹¹⁷ Federal common law evolved so that, following a partial settlement, a trial court would issue an order barring co-defendants from seeking indemnity or contribution from one another,¹¹⁸ and thereby creating “global peace” for the settling parties.¹¹⁹ In return, the non-settling

risks of maintaining the class action through trial; (7) The ability of the defendants to withstand a greater judgement; (8) The range of reasonableness of the settlement fund in light of the best possible recovery; and, (9) The range of reasonableness of the settlement fund to the best possible recovery in light of all the attendant risks of litigation.

PNC, 440 F. Supp. 2d at 430 (citing *Girsh v. Jepson*, 521 F.2d 153, 157 (3d Cir. 1975)).

¹¹⁷ See, e.g., *AmeriPride Servs. Inc. v. Valley Indus. Servs., Inc.*, No. CIV. S-00-113-LKK JFM, 2007 WL 1946635, at *3 (E.D. Cal. July 2, 2007):

[T]he parties have demonstrated that the decision to settle was motivated by the desire of each to avoid the significant costs required to further litigate this case as well to avoid the uncertainty of litigation. Settlement was also motivated in each case by the settling parties’ desire for finality

¹¹⁸ Defendants have a statutory right of contribution against one another under Sections 9 and 18 of the Exchange Act and Section 11 of the Securities Act, but not under Sections 12 and 15 of the Securities Act or Sections 16 and 20A of the Exchange Act. 15 U.S.C.A. §§ 78i(e), 78r(b), 77k(f), 77l, 77o, 78p, 78t-1 (West 2010). There is also an implied right of contribution under Section 10(b) of the Exchange Act. § 78j(b); *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 288 (1993). However, there is no express or implied right of indemnification. See, e.g., *Eichenholtz v. Brennan*, 52 F.3d 478, 483 (3d Cir. 1995) (collecting cases). Although the Reform Act only mandates a bar on contribution, courts have interpreted this to allow a bar on indemnity as well, consistent with prior federal common law practice. See, e.g., *HealthSouth*, 572 F.3d at 860 (“We believe that it is highly unlikely that Congress would intend by its mere silence to overrule such well-established case law.”). See generally David Kaplan, Note, *The Scope of Bar Orders in Federal Securities Fraud Settlements*, 52 DUKE L.J. 211, 218–28 (2002) (discussing the types of claims that are barred). Similar practice exists under various state laws. See also, e.g., CAL. CIV. PROC. CODE § 877.6 (West 2010); DEL. CODE ANN. tit. 10 § 6304(b) (West 2010); N.Y. GEN. OBLIG. L. § 15-108(b) (McKinney 2010).

¹¹⁹ See *HealthSouth*, 572 F.3d at 862 (“Defendants buy little peace through settlement unless they are assured that they will be protected against codefendants’ efforts to shift their losses through cross-claims for indemnity, contribution, and other causes related to the underlying litigation.” (quoting *In re U.S. Oil & Gas Litig.*, 967 F.2d 489, 494 (11th Cir. 1992))); *Wm. Bruce*

defendants received a judgment credit, or “set-off,”¹²⁰ precluding double recovery by plaintiffs and insulating the non-settling defendants from paying more than their share, based on a determination of proportionate liability.¹²¹ Bar orders facilitate pre-trial settlement of complex class actions, which is favorable because it results in financial savings to the parties and conservation of judicial resources.¹²² However, civil settlements may “do a poor job of sorting strong claims of fraud from non-fraudulent statements that were proved wrong only in hindsight. [Since] both weak and strong cases lead to settlements, the deterrent effect of class actions [is] diluted because both innocent

Davis, Note, *Multiple Defendant Settlement in 10b-5: Good Faith Contribution Bar*, 40 HASTINGS L.J. 1253, 1254 n.6 (1989) (“If a defendant’s settlement with the plaintiff does not sever liability to the nonsettling defendants, the settling defendants remains potentially liable for the entire judgment by virtue of a cross-claim for contribution . . . [and] there is little incentive to settle . . .”).

¹²⁰ Prior to the Reform Act, plaintiffs generally argued for a *pro tanto* approach, or a set-off based on the amount paid by the settling defendant, and defendants generally argued for a relative fault approach, or a set-off based on the relative fault of the settling defendant. See generally James J. Hagan, LL.B. & Joseph M. McLaughlin, *Fairness in the Balance: The Use of Bar Orders and Judgment Reduction in the Settlement of Multi-Defendant Securities Litigation*, 1 STAN. J.L. BUS. & FIN. 29 (1994). The Reform Act provides the non-settling defendant with the greater of the two. See, e.g., *PNC*, 440 F. Supp. 2d at 440–42 (recognizing that the Reform Act “assur[es] that the class bears all risk in brokering a partial settlement and retains the incentive to ascertain and prove each defendant’s fair share of damages”).

¹²¹ 15 U.S.C.A. § 78u-4(f)(7)(B) (West 2010):

If a covered person enters into a settlement with the plaintiff prior to final verdict or judgment, the verdict or judgment shall be reduced by the greater of (i) an amount that corresponds to the percentage of responsibility of that covered person; or (ii) the amount paid to the plaintiff by that covered person.

¹²² See, e.g., *PNC*, 440 F. Supp. 2d at 429–30 (“[T]here is an overriding public interest in settling class action litigation, and it is to be encouraged by the courts, particularly in complex settings that will consume substantial judicial resources and have the potential to linger for years.” (quoting *In re Warfarin Sodium Antitrust Litig.*, 391 F.3d 516, 535 (3d Cir. 2004))); 141 CONG. REC. S17933–34 (daily ed. Dec. 5, 1995) (statement of Sen. D’Amato) (“The threat of a protracted securities class action lawsuit is powerful. Companies pony up huge settlements rather than face the time and expense of a class action lawsuit . . .”).

and wrongful conduct leads to sanctions.”¹²³

Additionally, proportionate liability in conjunction with the mandatory bar on post-settlement contribution creates inefficient incentives during settlement negotiations because “on one hand, if the [individual defendants] remain in an action where [an] imbalance of wealth is present, the plaintiff will be able to collect the entirety of a judgment from other [] violators regardless of what percentage of responsibility the jury assigns to the [individual defendants].”¹²⁴ On the other hand, if the individual defendants settle, the set-off they receive will reduce the plaintiffs’ overall recovery.¹²⁵ Additionally, in cases where the defendants with deep pockets do not settle, plaintiffs have little incentive to give up a substantial proportion of their potential recovery by settling with individual defendants.¹²⁶

Following the Reform Act, there was an initial decline in federal court filings of securities litigation.¹²⁷ However, this deficit was only a reflection of a temporary shift in forum selection from federal to state courts.¹²⁸ In 1998, Congress enacted the Securities

¹²³ *Shareholder Wealth*, *supra* note 8, at 784.

¹²⁴ *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288(DLC), 2005 WL 335201, at *15 n.20 (S.D.N.Y. Feb. 14, 2005) (“It should be noted that this disincentive toward settlement with comparatively less wealthy parties is created in the Exchange Act context as well when the facts are such that one or more wealthy defendants are likely to be subject to joint and several liability for knowing conduct.”).

¹²⁵ *Id.* at *15.

¹²⁶ *Id.*

¹²⁷ MUKESH BAJAJ ET AL., CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: AN EMPIRICAL ANALYSIS 3 (2000), *available at* http://securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.html (“[T]he number of cases filed in Federal courts immediately following PSLRA dropped from 191 in 1995 to 119 in 1996.”).

¹²⁸ See Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641, 643–44 (1997):

A new breed of forum shopping [] developed resulting in [] an increase in standalone state securities class actions . . . 40% of the securities class actions filed in the first ten months of 1996 were filed in state courts, compared to slightly more than 20% during 1995.

See also JOSEPH A. GRUNDFEST & MICHAEL A. PERINO, CORNERSTONE RESEARCH, SECURITIES LITIGATION REFORM: THE FIRST YEAR’S EXPERIENCE (1997), *available at* <http://securities.stanford.edu/research/studies/19970227first>

Litigation Uniform Standards Act, which prohibited plaintiffs from filing a majority of class action securities litigations in state courts.¹²⁹ A decade later, class action securities litigations are filed in federal courts in similar numbers as in pre-Reform Act years.¹³⁰ Additionally, just about every case still results in settlement,¹³¹ indicating that once a claim survives a dispositive motion, defendants are in a similar position as they were prior to the Reform Act, favoring settlement to uncertainty and seeking to avoid the costs of litigation and discovery, rather than contesting liability.¹³²

yr_firstyr.html ("About 26% of litigation activity has moved from federal to state court.").

¹²⁹ 15 U.S.C.A. § 78bb(f)(1) (West 2010):

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

¹³⁰ CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2008: A YEAR IN REVIEW 2 (2008), *available at* http://securities.stanford.edu/clearinghouse_research/2008_YIR/20090106_YIR08_Full_Report.pdf ("A total of 210 federal securities class actions . . . were filed in 2008, a 19 percent increase over the 176 filings in 2007 91 of those filings are related to the subprime/liquidity crisis."). The yearly average between 1997 and 2007 was 192. *Id.*

¹³¹ STEPHANIE PLANCICH & SVETLANA STARYKH, NERA ECON. CONSULTING, 2008 TRENDS IN SECURITIES CLASS ACTIONS 7 (2008), *available at* http://www.nera.com/image/Recent_Trends_Report_12-08.pdf (finding that of the cases resolved in a five year period, 45% were dismissed and 55% reached settlement and that "[f]or example, only four of the cases filed in 2000 [went] to trial, and all settled with at least one defendant during the trial").

¹³² Moreover, investor recovery has not improved. In the first half of 2010, for example, "the median ratio of settlements to investor losses [was still only] 3.1%, a proportion higher than or equal to that observed in any year since 2002." JORDAN MILEV ET AL., NERA ECON. CONSULTING, TRENDS 2010 MID-YEAR STUDY 2 (WEST 2010), *available at* http://www.nera.com/67_6813.htm. *See also, e.g., In re Marsh & McLennan Cos. Sec. Litig.*, No. 04 Civ. 8144(CM), 2009 WL 5178546, at *7 (S.D.N.Y. Dec. 23, 2009) ("The fact that a proposed settlement may only amount to a fraction of the potential recovery does not, in and of itself, mean that the proposed settlement is grossly inadequate and should

II. PROPOSED MODIFICATIONS FOR CIVIL ENFORCEMENT

Despite objections from several members of Congress, including Senator Dodd, a lead sponsor of the bill,¹³³ and Arthur Levitt, then Chairman of the SEC,¹³⁴ the Reform Act was passed without two significant proposed amendments intended “(i) to increase the uncollectible share provision for proportionate liability from 50% to 100%; and (ii) to provide for liability in private actions under Rule 10b-5 for aiders and abettors of primary securities law violators.”¹³⁵ Future incorporation of these provisions would ensure greater recovery for injured shareholders and increase deterrence through broader exposure to civil liability.

A. *Shifting the Burden of Insolvency*

An individual defendant may be unable to satisfy a large judgment awarded in a class action.¹³⁶ Under the current scheme of proportionate liability, plaintiffs must bear the risk that a defendant

be disapproved.” (quoting *City of Detroit v. Grinnell Corp.*, 495 F.2d 448, 455 & n.2 (2d Cir. 1974) (“In fact there is no reason, at least in theory, why a satisfactory settlement could not amount to a hundredth or even a thousandth part of a single percent of the potential recovery.”))).

¹³³ 141 CONG. REC. S17937 (daily ed. Dec. 5, 1995) (statement of Sen. D’Amato (quoting Sen. Dodd)).

¹³⁴ See Letter from Arthur Levitt & Steve Wallman, *reprinted in* 141 CONG. REC. S17935 (daily ed. Dec. 5, 1995) (“[W]e have consistently advocated reversal of Supreme Court decisions of *Lampf* and *Central Bank*. It is unfortunate that Congress has not restored these investor protections that were removed by the Supreme Court . . .”).

¹³⁵ See S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

¹³⁶ *Id.* at 14. See, e.g., *Tucker v. Scrushy*, No. CV 02-5212 AEH, 2009 WL 1709245 (Cir. Ct. Ala. June 18, 2009) (rendering a pre-set-off judgment of more than three billion dollars against the chief executive officer in a shareholder derivative action for securities fraud). See also *In re Initial Pub. Offering Sec. Litig.*, 226 F.R.D. 186, 204 (S.D.N.Y. 2005) (Congress intended to promote early settlement while “ensuring that a non-settling party would not be exposed to liability for *more* than its percentage of responsibility for plaintiffs’ damages.”); St. Eve & Pilz, *supra* note 88, at 210–11 (“[T]he plaintiff will bear the risk of the jury assigning a percentage of fault to an insolvent defendant . . .”).

may be insolvent, instead of allowing this risk to fall on the other, solvent defendants.¹³⁷ The Reform Act sought to protect relatively less culpable parties with deep pockets.¹³⁸ However, protecting any culpable party is achieved at the detriment to injured shareholders, who are victims of the fraud.¹³⁹ As proposed during the formation of the Reform Act, increasing the uncollectible share coverage from 50 percent to 100 percent would shift the risks of insolvency back to the parties who caused the losses.

B. A Private Right of Action Against Aiders and Abettors

Although the Reform Act failed to overrule prior Supreme Court rulings,¹⁴⁰ legislators have since proposed an additional amendment that would reinstate a private action for aiding and abetting violations of Section 10(b) and Rule 10b-5, echoing the calls for reform that followed *Central Bank*.¹⁴¹

For purposes of any private civil action implied under [Title 15], any person that knowingly or recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of this title to the same extent as the person to whom such assistance is provided.¹⁴²

¹³⁷ Donald C. Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 BUS. LAW. 1157, 1159 (1996).

¹³⁸ S. REP. NO. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685.

¹³⁹ Langevoort, *supra* note 137, at 1160–61 (“As between innocent investors and defendants who recklessly caused a securities fraud, why should the risk of defendant insolvency fall on the victims rather than the participants? . . . Why limit the accountants’ liability and leave the victims significantly undercompensated?”).

¹⁴⁰ *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

¹⁴¹ See, e.g., David J. Baum, *The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*, 44 AM. U. L. REV. 1817 (1995).

¹⁴² Liability for Aiding and Abetting Securities Violations Act of 2009, S. 1551, 111th Cong. (2009), available at <http://www.govtrack.us/congress/bill>.

Since outside actors are now only proportionately liable for their violations and are shielded from civil liability for aiding and abetting violations,¹⁴³ they lack accountability and incentive to fulfill their roles as gatekeepers. Increased liability exposure through modification of the proportionate liability scheme and codification of an aiding and abetting right of action would provide greater incentive for external actors to object to or report, rather than acquiesce to and thereby enable, securities violations.¹⁴⁴ Additionally, if outside entities with deep pockets were held jointly and severally liable,¹⁴⁵ injured plaintiffs would not bear the risk of a single defendant's insolvency.¹⁴⁶ If these changes were made, the

xpd?bill=s111-1551 (Introduced by Sen. Specter [D-PA]). In 2010, Representative Waters [D-NY] introduced a bill with identical language. Liability for Aiding and Abetting Securities Violations Act of 2010, H.R. 5042, 111th Cong. (2010), available at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.5042>.

¹⁴³ See John C. Coffee, Jr., *Limited Options: The Authors of the Sarbanes-Oxley Act Had the Right Diagnosis for the Corporate Scandals of the 1990s. But that Doesn't Mean They Had the Cure*, 2003-DEC LEGAL AFF. 52, 52 (2003) [hereinafter *Limited Options*].

¹⁴⁴ See, e.g., 141 CONG. REC. S17937 (daily ed. Dec. 5, 1995) (statement of Sen. D'Amato) ("Aiding and abetting liability has been critically important in deterring individuals from assisting possible fraudulent acts by others." (quoting Sen. Dodd)).

Persons who knowingly or recklessly assist the perpetration of a fraud may be insulated from liability to private parties if they act behind the scenes and do not themselves make statements directly or indirectly that are relied upon by investors. Because this is conduct that should be deterred, Congress should enact legislation to restore aiding and abetting liability in private actions.

Id. (quoting SEC Chairman Arthur Levitt). See also *Limited Options*, *supra* note 143, at 52, 55 ("[S]candals typically involved fraud by committee How did [Enron] learn to manipulate earnings in new state-of-the-art ways? It was taught to—by accountants, investment bankers, law firms, and banks").

¹⁴⁵ See, e.g., *Cent. Bank*, 511 U.S. at 193 n.2 ("All who actively participate in any manner in the commission of a tort, or who command, direct, advise, encourage, aid or abet its commission, are jointly and severally liable therefore." (citing 1 T. COOLEY, LAW OF TORTS 244 (3d ed. 1906))).

¹⁴⁶ See McDermott, *supra* note 66, at 1088–89 ("Aiding and abetting liability has become enormously important in recent years. Because the primary wrongdoer often is insolvent or bankrupt when the fraud is discovered, plaintiffs typically sue all the parties connected with a transaction, even if the connection

cost of liability insurance might rise to the point where it would be more efficient for large entities to self-insure through enhanced internal controls and diligence than to obtain insurance from a third-party.¹⁴⁷

III. PROPOSED ENHANCEMENT OF CRIMINAL PROSECUTION

In addition, or in the alternative, enhanced public enforcement could provide increased deterrence of securities fraud. Incentives for directors and officers, such as exorbitant salaries and bonuses paid after purported success, may overcome the deterrent effects of exposure to civil liability.¹⁴⁸ Additionally, insurance policies,¹⁴⁹

is highly attenuated, in search of a ‘deep pocket.’”).

¹⁴⁷ See generally John C. Coffee, Jr., *A Statutory and Case Law Primer on Due Diligence Under the Federal Securities Laws*, in CONDUCTING DUE DILIGENCE 1995, at 13 (PLI Corp. Law & Practice, Course Handbook Ser. 1995, 1995), available at Westlaw 886 PLI/Corp 11 (describing due diligence requirements for primary actors to avoid liability under SEC Rule 10b-5 and other securities provisions); Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 693 (1997):

[E]ntity liability can lead companies to institute “preventive measures” that deter by making misconduct more difficult or expensive for wrongdoers, or by reducing the illicit benefits of unpunished (or successful) misconduct, without affecting the probability that it is detected by enforcement officials. Such measures can assume many forms, ranging from personnel policies—for example, firing price fixers and raising the salaries of law abiding managers—to sophisticated financial controls, screening procedures, and similar mechanisms for limiting agents’ opportunities to commit misconduct. The commonality is that these preventive measures reduce the returns or increase the costs of misconduct to culpable agents—and so enhance deterrence—without affecting the probability that the firm is sanctioned.

¹⁴⁸ John C. Coffee, Jr., *A Theory of Corporate Scandals*, in SARBANES-OXLEY INSTITUTE: CORPORATE GOVERNANCE, FINANCIAL DISCLOSURE, AUDITING, AND OTHER ISSUES 523–24 (ALI-ABA’S THIRD ANNUAL ADVANCE, Ser. No. SK017, 2004) [hereinafter *Theory of Scandals*], available at Westlaw, SK017 ALI-ABA 519:

As of 1990, the median [CEO of an S&P 500 Industrial company] made \$1.25 million with 92% of that paid in cash and 8% in equity. But during the 1990s, both the scale and composition of executive

employment contracts,¹⁵⁰ and internal governance provisions often provide indemnification for individual defendants who settle prior

compensation changed. By 2001, the median CEO of an S&P industrial company was earning over \$6 million, of which 66% was in equity. Obviously, when you pay the CEO with stock options, you create incentives for short-term financial manipulation and accounting gamesmanship. Not only is this obvious, but financial economists have confirmed it, finding a strong statistical correlation between higher levels of equity compensation and financial restatements. CEO compensation as a multiple of average employee compensation is now 531:1 in the U.S.

See also, e.g., Declaration of Ira Lee Sorkin in Support of Defendant Bernard L. Madoff's Motion for Stay and Reinstatement of Bail Pending Sentencing Pursuant to 18 U.S.C.A. § 3143(a) at Ex. F, United States v. Madoff, No. 09-1025-cr (2d Cir. Mar. 13, 2009) [hereinafter Sorkin Decl.] (describing financial condition of defendant, which included assets worth approximately \$823 million).

¹⁴⁹ *See, e.g.,* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1570 ("D&O insurance now protects both the individual's assets and those of the corporation. As a result, allocation seemingly became unnecessary, because one insurer covered the exposure of virtually everyone."). There are two sides to this argument. On one hand, an inability to shift liability through indemnification may deter competent people from serving. On the other hand, courts and commentators have generally recognized that indemnification conflicts with the goals of encouraging diligence and deterring intentional and negligent violations of securities laws. *See, e.g., In re HealthSouth Corp. Sec. Litig.*, 572 F.3d 854, 862 (11th Cir. 2009) (citing 17 C.F.R. § 229.512(h)(3) (West 2010) (stating that the SEC's position is that indemnification to officers and directors for liabilities arising under the Securities Act is against public policy and such indemnification is unenforceable, with the exception for expenses incurred in successful defense of any action)); *Eichenholtz v. Brennan*, 52 F.3d 481, 485 (3d Cir. 1995) ("[C]ontractual indemnification allows an underwriter to shift its entire liability to the issuer before any allegation of wrongdoing or a determination of fault."); *In re PNC Fin. Servs. Group*, 440 F. Supp. 2d 421, 442 (W.D. Pa. 2006) ("Enforcing a claim for contractual indemnification, even where the defendant's liability is premised on negligence under the securities laws, would run counter to the prophylactic purpose of ensuring accurate investigating and reporting by all accountable parties responsible for public reports, particularly those who assume roles of verification and supervision.").

¹⁵⁰ *But see HealthSouth*, 572 F.3d 854 (upholding bar order that invalidated indemnity provision in CEO's employment contract).

to any determination of fault.¹⁵¹ In a recent five-year study by the U.S. Government Accountability Office, more than 10 percent of all listed companies had issued restated financials—“a serious event that, depending on its magnitude, often results in a private class action, an SEC enforcement proceeding, a major stock price drop, and/or a management shake up.”¹⁵² After the passage of the Reform Act, lawsuits alleging accounting fraud and insider trading increased significantly.¹⁵³ While many more cases are dismissed because of the heightened pleading standard,¹⁵⁴ discounting meritless cases that survived the former pleading standard, these numbers may indicate that the incidence of misconduct has remained consistent.

Enhanced criminal enforcement and mandatory minimum sentences may be a more effective deterrent than any scheme of civil liability. Although it is difficult to measure the deterrent effect of either civil liability or criminal enforcement, “[a] consensus appears to exist that greater use should be made of the criminal law in combating securities fraud and accounting irregularities.”¹⁵⁵ Criminal actions may be more successful for several reasons: conduct that is not actionable as civil securities fraud may be criminally prosecuted;¹⁵⁶ the materiality standard for wire and mail fraud is lower than for securities fraud;¹⁵⁷ the safe harbor does not shield speakers from criminal liability;¹⁵⁸ aiders and abettors are subject to criminal liability;¹⁵⁹ and criminal

¹⁵¹ See 15 U.S.C.A. § 78u-4(f)(3) (West 2010).

¹⁵² *Theory of Scandals*, *supra* note 148, at 521 (citing U.S. GEN. ACCT. OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES AND REMAINING CHALLENGES 4 (2002)).

¹⁵³ *Do Merits Matter More?*, *supra* note 39, at 637.

¹⁵⁴ See *supra* notes 96–98 and accompanying text.

¹⁵⁵ John C. Coffee, Jr., Professor, Columbia Univ. Sch. of Law, Statement Before the Subcommittee on Crime and Drugs (July 10, 2002) [hereinafter *Getting Tough*], reprinted in 15 FED. SENT’G REP. 245, 245 (2003).

¹⁵⁶ See Wendy Gerwick Couture, *White Collar Crime’s Gray Area: The Anomaly of Criminalizing Conduct Not Civilly Actionable*, 72 ALB. L. REV. 1, 3–4 (2009).

¹⁵⁷ *Id.* at 6.

¹⁵⁸ See 15 U.S.C.A. § 78u-5 (West 2010) (creating safe harbor provision in private securities litigation).

¹⁵⁹ Couture, *supra* note 156, at 15.

indictments are less likely to be dismissed before trial than civil complaints.¹⁶⁰

In theory, “a penalty of 25 years imprisonment with a probability of .01 is unlikely to be as effective a deterrent as a [penalty of] 2.5 year[s] [imprisonment] . . . with a probability of .1.”¹⁶¹ Compliance arguably depends on the expectation of detection and prosecution; if actors believe that their the risk of punishment is high, they may be more likely to comply than if they believe that their the risk is low.¹⁶² Therefore, “the passage of tough mandatory sentences that impose exemplary sentences on white collar offenders [may] do less to achieve deterrence than investment in enforcement and detection.”¹⁶³

A remaining consideration in criminal actions is the compensation of injured shareholders.¹⁶⁴ Although the government may seek forfeiture,¹⁶⁵ individuals who are found guilty of securities violations may have long since enjoyed the profits of their crimes,¹⁶⁶ meaning that recovered funds are insignificant when compared with investor losses.¹⁶⁷ Additionally, trial courts may circumvent crime victims’ statutory right to restitution¹⁶⁸—because of complex issues such as loss causation—to avoid unduly

¹⁶⁰ *Id.* at 21.

¹⁶¹ Symposium, *Federal Sentencing Policy for Economic Crimes and New Technology Offenses: What Social Science Can Contribute to Sentencing Policy for Economic Crimes*, at 23 (2000), available at <http://www.ussc.gov/2000sympo/2000sympo.htm>.

¹⁶² *Getting Tough*, *supra* note 155, at 246.

¹⁶³ *Id.*

¹⁶⁴ See generally Couture, *supra* note 156, at 39–40.

¹⁶⁵ See, e.g., 18 U.S.C.A. §§ 981; 982 (West 2010).

¹⁶⁶ See Sorkin Decl., *supra* note 148.

¹⁶⁷ For example, it is estimated that Bernard Madoff caused \$65 billion in losses to investors, but forfeited only \$823 million. See Sorkin Decl., *supra* note 148; Michael Moore, *The 2009 Time 100: Bernie Madoff*, TIME, Apr. 30, 2009, available at http://www.time.com/time/specials/packages/article/0,28804,1894410_1893837_1894189,00.html. See also MILEV ET AL., *supra* note 132.

¹⁶⁸ Crime Victim Restitution Act of 2005, 18 U.S.C.A. § 3771(a)(6) (West 2010). Specifically, restitution is available for any “offense against property under [Title 18] . . . including any offense committed by fraud or deceit.” Mandatory Victim Restitution Act of 1996, 18 U.S.C.A. § 3663A(c)(1)(A)(ii) (West 2010).

long or complicated sentencing.¹⁶⁹

CONCLUSION

Enforcement and exposure to civil liability produces both costs and benefits. For example, harsher punishments and greater liability may influence companies to prefer foreign markets.¹⁷⁰ However, it is important to recognize that “[s]ecurities fraud has macro-economic consequences. It injures not only investors, but the public generally by raising the cost of capital for all corporations and thereby retarding economic growth, increasing interest rates, and producing inevitable layoffs.”¹⁷¹ Moreover, there

¹⁶⁹ 18 U.S.C.A. §§ 3663A(3), 3771(d)(2) (West 2010); FED. R. CRIM. P. 60(b)(3); 150 CONG. REC. S10910 (daily ed. Oct. 9, 2004) (statement of Sen. Kyl):

[A] court may find that the sheer number of victims is so large that it is impracticable to accord each victim the rights in this bill [T]he court must then fashion a procedure that still gives effect to the bill and yet takes into account the impracticability.

See, e.g., United States v. Saltsman, No. 07-CR-641, 2007 WL 4232985, at *1 (E.D.N.Y. Nov. 27, 2007) (finding that ‘tens of thousands’ of potential victims made identification, location, and notice impracticable). *See also* § 3663(a)(1)(B); U.S. SENTENCING GUIDELINES MANUAL §§ 5E1.1(b)(2); 8B1.1(b)(2) (2009); S. REP. NO. 104-179, at 18–19 (1995), *reprinted in* 1996 U.S.C.C.A.N. 924, 931 (“It is the committee’s intent that courts order full restitution to all identifiable victims of covered offenses, while guaranteeing that the sentencing phase of criminal trials do not become fora for the determination of facts and issues better suited to civil proceedings.”). Generally, courts also recognize that alternative civil remedies are available for injured investors—the Mandatory Victim Restitution Act precludes double recovery and an award of restitution is ultimately reduced by the damages recovered in any civil action. 18 U.S.C.A. § 3664(j)(2) (West 2010). *See also, e.g.,* United States v. Stanley, 309 F.3d 611 (9th Cir. 2002). However, as an alternative, the government may compensate victims from assets obtained through forfeiture. *See, e.g., In re W.R. Huff Asset Mgmt Co.*, 409 F.3d 555 (2d Cir. 2005).

¹⁷⁰ ABA COMM. ON FED. REG. OF SEC., REPORT OF THE TASK FORCE OF SECURITIES, *reprinted in* 47 BUS. LAW. 1083, 1138 n.270 (1992) (“[T]he layers of regulation and enforcement currently in place within our country are deterring international business ventures and securities offerings participation within the United States.”).

¹⁷¹ *Getting Tough*, *supra* note 155, at 247. *See also Law and the Market*, *supra* note 31, at 230 (“[H]igher enforcement intensity gives the U.S. economy a

is circularity underlying securities class actions; although they may result in substantial settlements, damages assessed directly against an issuer, or indirectly through the indemnification of its directors and officers, ultimately come from shareholders' equity.¹⁷²

The Reform Act had small successes in eliciting enhanced issuer disclosure and filtering out some strike suits. However, it reduced the chances that injured shareholders will be made whole through class actions and missed an opportunity to codify a private right of action for aiding and abetting violations of Section 10(b) and Rule 10b-5. In the wake of America's most recent financial crisis,¹⁷³ additional oversight for issuers, officers and directors, and third-party gatekeepers should be a legislative priority. For defendants, deterrence is a question of pricing and prohibiting.¹⁷⁴ Where civil liability exceeds the ability of culpable actors to pay, pricing may be irrelevant. Ultimately, it may be more effective to shift the focus to prevention through deterrence, which may be achieved more efficiently through changes in the scheme of proportionate liability, the expansion of liability for outside entities, and/or the enhancement of regulatory and criminal enforcement.

lower cost of capital and higher securities valuations.”).

¹⁷² Symposium, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545 (2006):

From a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly. Settlements recover only a very small share of investor losses. NERA Economic Consulting annually prepares a table showing the ratio of settlements to investor losses, and between 1991 and 2004, this ratio has never exceeded 7.2%

....

(citing ELAINE BUCKBERG ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLD COM AND ENRON THE NEW STANDARD? 6 (2005)).

¹⁷³ See, e.g., *Tucker v. Scrushy*, No. CV 02-5212 AEH, 2009 WL 1709245 (Cir. Ct. Ala. June 18, 2009).

¹⁷⁴ See generally John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can be Done About It*, 101 YALE L.J. 1875 (1992) (discussing the differences between pricing and sanctioning undesirable conduct).